

## Internal Revenue Service

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### Legend:

X =

D1 =

D2 =

Y1 =

State =

a =

b =

c =

Dear :

This responds to a letter dated February 20, 2009, submitted on behalf of X, requesting a ruling that X's rental income from its rental activities is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

### Facts

The information submitted states that X was incorporated on D1 pursuant to the laws of State. X elected to be an S corporation effective D2. X has accumulated earnings and profits from prior years.

X owns a separate commercial rental properties that are leased to tenants (collectively “the Properties”). X, through its shareholders, provides certain services with respect to the leasing of the Properties. These services involve maintaining and repairing the buildings, appurtenances, and grounds of the Properties. In addition, X represents that it negotiates leases and rental arrangements; collects rents; monitors compliance with lease terms; arranges, supervises, and pays for maintenance and repair works; pays property taxes; and maintains casualty insurances.

In Y1, X collected approximately \$b in gross rents and incurred approximately \$c in relevant operating expenses.

### Law and Analysis

Section 1361(a)(1) defines an “S corporation” as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) shall be terminated whenever the corporation has accumulated earnings and profits at the close of each of 3 consecutive taxable years, and has gross receipts for each of such taxable years more than 25 percent of which are passive investment income. Any termination under this paragraph shall be effective on and after the first day of the first taxable year beginning after the third consecutive taxable year referred to above.

Section 1362(d)(3)(C)(i) provides that except as otherwise provided, the term “passive investment income” means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1.1362-2(c)(5)(ii)(B)(2) of the Income Tax Regulations provides that “rents” does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

### Conclusion

Based solely on the facts and the representations submitted we conclude that the rental income that X derives from the Properties is not passive investment income as described in § 1362(d)(3)(C)(i).

Except as specifically set forth above, we express no opinion as to the federal tax consequences of the transaction described above under any other provision of the Code. Specifically, we express no opinion on whether X is a small business corporation eligible to make an S election. Further, the passive investment income rules of § 1362 are completely independent of the passive activity rules of section § 469; unless an exception under § 469 applies, the rental activity remains passive for purposes of § 469.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

*David R. Haglund*

David R. Haglund  
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Office of Associate Chief Counsel  
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Enclosures (2)

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Copy of this letter for § 6110 purposes

cc: